Monetary Policy and the Economy in 1998

In 1998, the U.S. economy again performed impressively. Output expanded rapidly, the unemployment rate fell to its lowest level since 1970, and inflation remained subdued. Transitory factors, most recently falling prices for imports and commodities, especially oil, have helped produce the favorable outcomes of recent years, but technological advances and increased efficiency, likely reflecting in part heightened global competition and changes in business practices, suggest that some of the improvement will be more lasting.

Sound fiscal and monetary policies have contributed importantly to the good economic results of recent years: Budgetary restraint at the federal level has bolstered national saving and permitted the Federal Reserve to maintain lower interest rates than would otherwise have been possible. This policy mix and sustained progress toward price stability have fostered clearer price signals, more efficient resource use, robust business investment, and sizable advances in the productivity of labor and the real wages of workers. The more rapid expansion of productive potential has, in turn, helped keep inflation low even as aggregate demand surged and labor markets tightened.

Nonetheless, economic troubles abroad posed a significant threat to the economy's performance in 1998. Foreign economic growth slowed markedly, on average, as conditions in many countries deteriorated. The recession in Japan deepened, and several emerging market economies in Asia, which had started to weaken in the wake of the financial crises of 1997, contracted sharply. A worsening economic situation in Russia during the summer led to a devaluation of the ruble and a moratorium by that country on a substantial portion of its debt payments. As the year progressed, conditions in Latin America also weakened. Although some of the troubled foreign economies were showing signs of improvement by the end of the year, others either were not yet in recovery or were still contracting.

The Russian crisis in mid-August precipitated a period of unusual volatility in world financial markets. The losses incurred in Russia and other emerging market economies heightened investors' and lenders' concerns about other potential problems and led them to become substantially more cautious about taking on risk. The resulting effects on U.S. financial markets included a substantial widening of risk spreads on debt instruments, a jump in measures of market uncertainty and volatility, a drop in equity prices, and a reduction in the liquidity of many markets. To cushion the U.S. economy from the effects of financial strains here and abroad, and potentially to help reduce the strains as well, the Federal Reserve eased monetary policy on three occasions in the fall. Global financial market stresses lessened somewhat after mid-autumn, reflecting, in part, these policy steps as well as interest rate cuts in other industrial countries and international efforts to provide support to troubled emerg-

NOTE. The discussion here and in the next chapter is adapted from *Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 1999). The data cited in these two chapters are those available as of mid-March 1999.

ing market economies. Although some U.S. financial flows were disrupted for a time, most firms and households remained able to obtain sufficient credit, and the turbulence did not appear to constrain spending significantly.

The foreign exchange value of the dollar rose substantially against the currencies of the major foreign industrial countries over the first eight months of 1998, but it subsequently fell sharply, ending the year down a little on net. The dollar's appreciation in the first half of the year carried it to an eight-year high against the Japanese yen. In June, this strength prompted the first U.S. foreign exchange intervention operation in nearly three years, an action that appeared to slow the dollar's rise against the yen over the following weeks. Later in the summer, concerns about the possible impact on the U.S. economy of increasing difficulties in Latin America began to weigh on the dollar's exchange value against major foreign currencies. After peaking in mid-August, it fell sharply over the course of several weeks, reversing by mid-October the appreciation that had occurred earlier in the year. The depreciation during this period was particularly sharp against the yen. The reasons for this decline against the yen are not clear, but repayment of yen-denominated loans by international investors and decisions by Japanese investors to repatriate their assets in light of increased volatility in global markets seem to have contributed. The dollar's exchange value fluctuated moderately against the major currencies over the rest of the year. At year-end, the launch of the third stage of European Economic and Monetary Union fixed the eleven participating countries' conversion rates and created a new common currency, the euro.

With the U.S. economy expanding rapidly, the economies of many U.S. trading partners struggling, and the foreign exchange value of the dollar having risen over 1997 and the first part of 1998, the U.S. trade deficit widened considerably in 1998. Some domestic industries were especially affected by lower foreign demand or increased competition from imports. For example, a wide range of commodity producers, notably those in agriculture, oil, and metals, experienced sharp price declines. Parts of the manufacturing sector also suffered adverse consequences from the shocks from abroad. Overall, real net exports deteriorated sharply, as exports stagnated and imports continued to surge. The deterioration was particularly marked in the first half of the year; the second half brought a further, more modest, net widening of the external deficit.

Meanwhile, domestic spending continued to advance rapidly. Household expenditures were bolstered by gains in real income and a further rise in wealth, while a low cost of capital and optimism about future profitability spurred businesses to invest heavily in new capital equipment. Although securities markets were disrupted in late summer and early fall, credit generally remained available from alternative sources. Once the strains on securities markets had eased, businesses and households generally had ready access to credit and other sources of finance on relatively favorable terms, although spreads in some markets remained quite elevated, especially for lower-rated borrowers. All told, household and business outlays rose even more rapidly than in 1997, and that acceleration kept the growth of real GDP strong even as net exports were slumping.

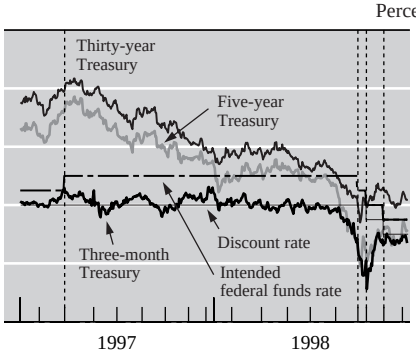
Deteriorating economic conditions abroad, coupled with the strength of the dollar over the first eight months of the year, helped hold down inflation in

the United States by trimming the prices of oil and other imports. These declines reduced both the prices paid by consumers and the costs of production in many lines of business, and the competition from abroad kept businesses from raising prices as much as they might have otherwise. As a result of the reduced rate of price inflation, workers enjoyed a larger rise in real purchasing power even as increases in nominal hourly compensation picked up only slightly on average. Because of increased gains in productivity, corporations in the aggregate were able to absorb the larger real pay increases without suffering a serious diminution of profitability.

Monetary policy in 1998 needed to balance two major risks to the economic expansion. On the one hand, with the domestic economy displaying considerable momentum and labor markets tight, the Federal Open Market Committee (FOMC) was concerned about the possible emergence of imbalances that would lead to higher inflation and thereby, eventually, put the sustainability of the expansion at risk. On the other hand, troubles in many foreign economies and resulting financial turmoil both abroad and at home seemed, at times, to raise the risk of an excessive weakening of aggregate demand.

Over the first seven months of the year, neither of these potential tendencies was sufficiently dominant to prompt a policy action by the FOMC. Although the incoming data gave no evidence of a sustained slowing of output growth, the Committee members believed that the pace of expansion would likely moderate as businesses began to slow the rapid rates at which they had been adding to their stocks of inventories and other investment goods, and as households trimmed the large advances in their spending on homes and consumer durable goods. Relatively firm real interest rates, buoyed by a high real federal funds rate resulting from the decline in the level of expected inflation, were thought likely to help restrain the growth of spending by businesses and households. Another check on growth was expected to come from the effects on imports and exports of the economic difficulties in emerging market economies in Asia and elsewhere. Indeed, production in the manufacturing sector slowed substantially in the first half of the year, and capacity utilization dropped noticeably. Moreover, inflation remained subdued, and a pickup was not expected in the near-to-intermediate term because of declining oil prices and because economic weakness abroad and the appreciation of the dollar were expected to trim the prices of imported goods and to increase price competition for many U.S. producers. Nonetheless, with labor markets already quite taut and aggregate demand growing rapidly—a combination that often has signaled the impending buildup of inflationary pressures—the Committee, at its meetings from March through July,

Selected Interest Rates



NOTE. The data are daily. Short ticks indicate days on which the Federal Open Market Committee held a scheduled meeting or a policy action was announced. Vertical lines mark days on which policy actions were announced: March 25, 1997; and September 29, October 15, and November 17, 1998.

judged conditions to be such that, if a policy action were to be taken in the period immediately ahead, it more likely would be a tightening than an easing; its directives to the Account Manager of the Domestic Trading Desk at the Federal Reserve Bank of New York noted that asymmetry.

By the time of the August FOMC meeting, however, the situation was changing. Although tight labor markets and rapid output growth continued to pose a risk of higher inflation, the damping influence of foreign economic developments on the U.S. economy seemed likely to increase. The contraction of the emerging market economies in Asia appeared to be deeper than had been anticipated, and the economic situation in Japan had deteriorated. Financial markets in some foreign economies also had experienced greater turmoil, and, the day before the Committee met, Russia was forced to devalue the ruble. These difficulties had been weighing on U.S. asset markets. Stock prices had fallen sharply in late July and into August as investors became concerned about the outlook for profits, and risk spreads in debt markets had widened, albeit from very low levels. Taking account of these circumstances, the Committee again left monetary policy unchanged at the August meeting, but it shifted to a symmetric directive, reflecting its perception that the risks to the economic outlook, at prevailing short-term rates, had become roughly balanced.

Over subsequent weeks, conditions in financial markets and the economic outlook in many foreign countries deteriorated further, increasing the dangers to the U.S. expansion. With investors around the world apparently reevaluating the risks associated with various credits and seemingly becoming less willing or less able to bear such risks, asset demands shifted toward safer and more liquid instruments. These shifts caused a sharp fall in yields on Treasury securities. Spreads of yields on private debt securities over those on comparable Treasury instruments widened considerably further, and issuance slowed sharply. Measures of market volatility increased, and liquidity in many financial markets was curtailed. Equity prices continued to slide lower, with most broad indexes falling back by early September to near their levels at the start of the year. Reflecting the weaker and more uncertain economic outlook, some banks boosted interest rate spreads and fees on new loans to businesses and tightened their underwriting standards.

Against this backdrop, the FOMC at its September meeting looked beyond incoming data suggesting that the economy was continuing to expand at a robust pace, and it lowered the intended level of the federal funds rate ¼ percentage point. The Committee noted that the rate cut would cushion the effects on prospective U.S. economic growth of increasing weakness in foreign economies and of less accommodative conditions in domestic financial markets. The directive adopted at the meeting suggested a bias toward further easing over the intermeeting period. In the days following the policy move, disturbances in financial markets worsened. Movements in the prices of securities were exacerbated by a deterioration in market liquidity, as some securities dealers cut back on their market-making activities, and by the increased anticipation of an unwinding of positions by hedge funds and other leveraged investors. In early October, Treasury yields briefly tumbled to their lowest levels in many years, reflecting efforts by investors to exchange other instruments for riskless and liquid Treasury securities.

Although some measures of market turbulence had begun to ease a bit by mid-October, financial markets remained extremely volatile, and risk spreads were very wide. On October 15, consistent with the directive from the September meeting, the intended federal funds rate was trimmed another ¼ percentage point, to 5 percent. This policy move, which occurred between FOMC meetings, came at the initiative of Chairman Greenspan and followed a conference call with Committee members. At the same time, the Board of Governors approved a ¼ percentage point reduction in the discount rate. These actions were taken to buffer the domestic economy from the impact of the less accommodative conditions in domestic financial markets, perhaps in part by contributing to some stabilization of the financial situation.

Following the October policy move, strains in domestic financial markets diminished considerably. As safe-haven demands for Treasury securities ebbed, Treasury yields generally trended higher, and measures of financial market volatility and illiquidity eased. Nonetheless, risk spreads remained very wide, and liquidity in many markets continued to be limited. Moreover, although pressures on some emerging market economies had receded a bit, partly reflecting concerted international efforts to provide assistance to Brazil, the foreign economic outlook remained uncertain. With downside risks still substantial, and in light of the cumulative effect since August of the tightening in many credit markets and the weakening of economic activity abroad, the FOMC reduced the intended federal funds rate a further ¼ percentage point at its November meeting, bringing the total reduction during the autumn to ¾ percentage point. The Board of Governors also approved a second ¼ percentage point cut in the discount rate. The Committee believed that, with this policy action, financial conditions could reasonably be expected to be consistent with fostering sustained economic expansion while keeping inflationary pressures subdued. The action provided some insurance against an unexpectedly severe weakening of the expansion, and the Committee therefore established a symmetrical directive. By the time of the December meeting, the situation in financial markets had changed little, on balance, and the Committee decided that no further change in rates was desirable and that the directive should remain symmetrical. ▪